Testimony of Mark S. Streeter, CFA
Managing Director
North American Credit Research
JP Morgan Securities
Before the Subcommittee on Aviation
United States House of Representatives
June 22, 2005

Chairman Mica and Members of the Committee, thank you for inviting me to speak this afternoon. My name is Mark Streeter and I am responsible for airline credit research at JPMorgan. I would like to provide the Committee with a credit perspective on the airline industry and how the pension issue and other economic factors will continue to impact airline credit quality and access to capital. I will focus my comments on the remaining legacy airline defined benefit plan sponsors, specifically Delta Air Lines, Northwest Airlines, Continental Airlines, and AMR Corp. Please note that my testimony and statements are my personal views and do not represent the official position of JPMorgan.

Are the credit markets concerned?
Unfortunately for the airlines, the credit markets are very concerned about airline industry fundamentals and looming pension obligations, particularly at Delta and Northwest.

Using credit default swaps, it is fairly easy to estimate market implied default probabilities (Exhibit I).

Exhibit I: Credit Market Implied Cumulative Default Probabilities

Cumulative Default Probability Before Time Period Expires

	0.5-Yr	1-Yr	2-Yrs	3-Yrs	4-Yrs	5-Yrs
AMR Corp	6.9%	13.1%	32.2%	45.0%	57.0%	61.2%
Continental	7.3%	13.9%	33.4%	46.5%	58.5%	62.8%
Northwest	24.7%	43.1%	59.9%	70.8%	77.8%	82.9%
Delta	32.8%	54.6%	69.2%	79.4%	85.4%	89.5%

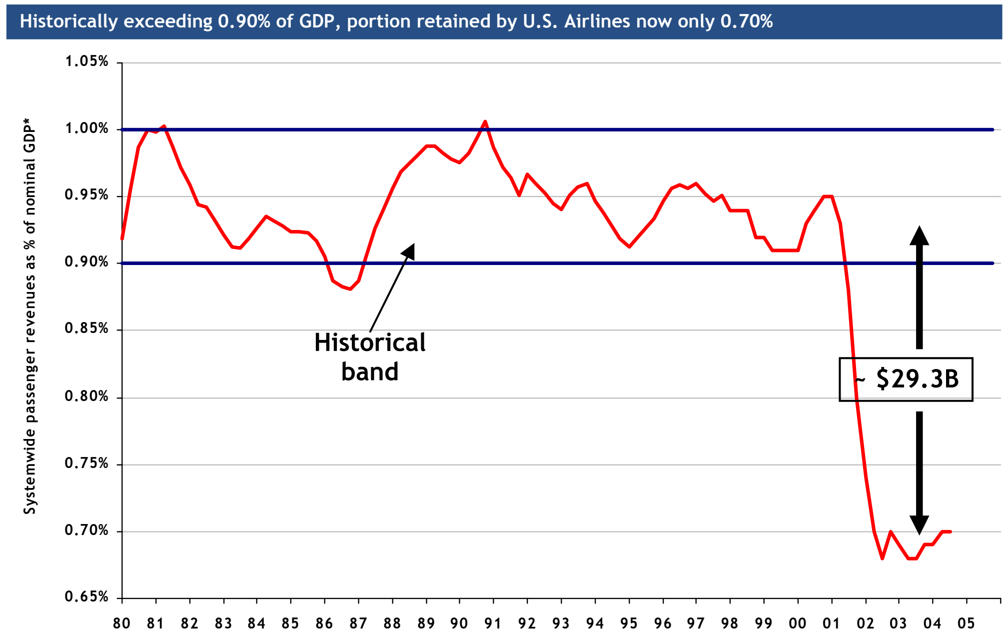
Source: JPMorgan, based on 16-June-05 credit default swap quotes assuming 10% recovery in bankruptcy

Based on current prices, the market believes with about 43% certainty that Northwest will file for Chapter 11 protection by June 10, 2006. For Delta, the implied one-year default risk is nearly 55%. Implied one-year default risk for AMR and Continental is relatively low, but rising to more than 50% when I extend the time frame to four years. These figures are slightly skewed by the sheer number of investors looking to hedge existing exposure to the airlines, but nonetheless the data are rather startling.

Yields on unsecured debt obligations are incredibly high. Delta bonds due in 2009 offer an annualized 40% yield and are trading at 35 cents to the dollar. Northwest bonds due that same year offer a 37% annual yield and are trading at 46 cents to the dollar.

Why are the credit markets worried?
There are several reasons why the credit markets are worried. You have heard others testify about the disconnect between industry revenue and overall economic growth since the attacks of September 11 (Exhibit II). Increased low cost competition, the decline in business travel, internet-driven pricing transparency, and SARS are major factors.

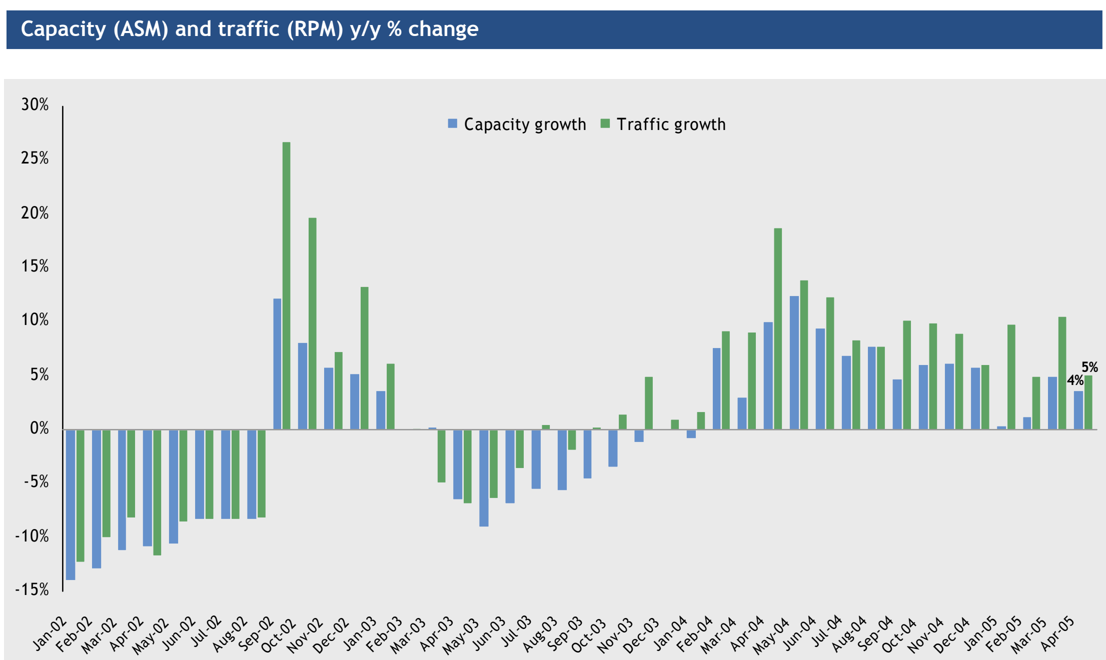
Exhibit II: Industry revenue may not recover from the dislocation of 9/11



*Four-quarter rolling passenger revenue derived from government filings of major and national passenger airlines.
Source: Air Transport Association, U.S. Bureau of Economic Analysis; U.S. Department of Transportation Form 41 reports.

The industry has responded to the new environment by cutting costs and shifting capacity to more profitable international routes. For 24 months running, traffic growth has exceeded capacity growth (Exhibit III). Load factors are at record levels, yet yields remain fairly anemic despite numerous successful fare increases year-to-date (Exhibits IV-V).

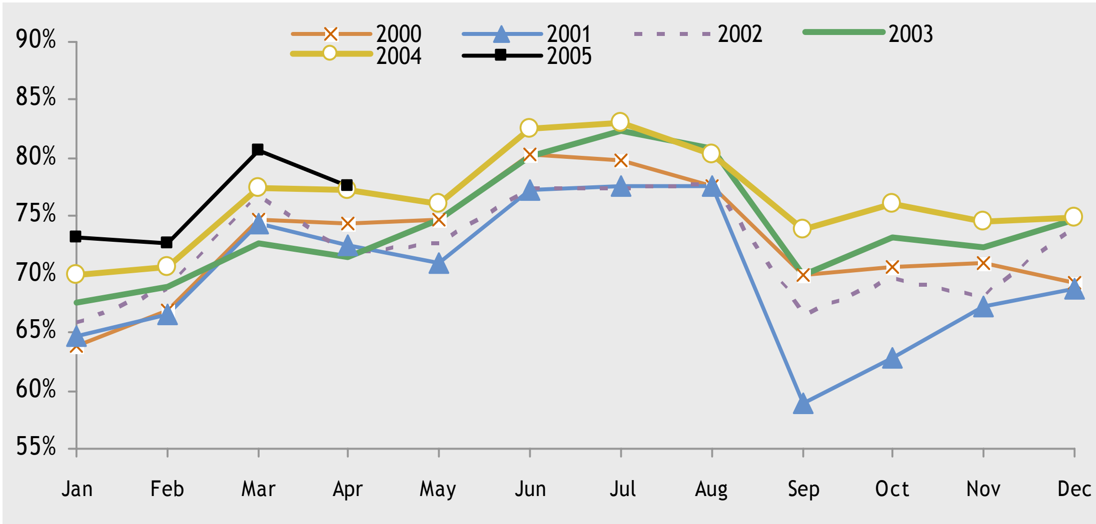
Exhibit III: Traffic continues to grow faster than capacity



Source: Air Transport Association.

Exhibit IV: People flying more, more passengers stuck in middle seats

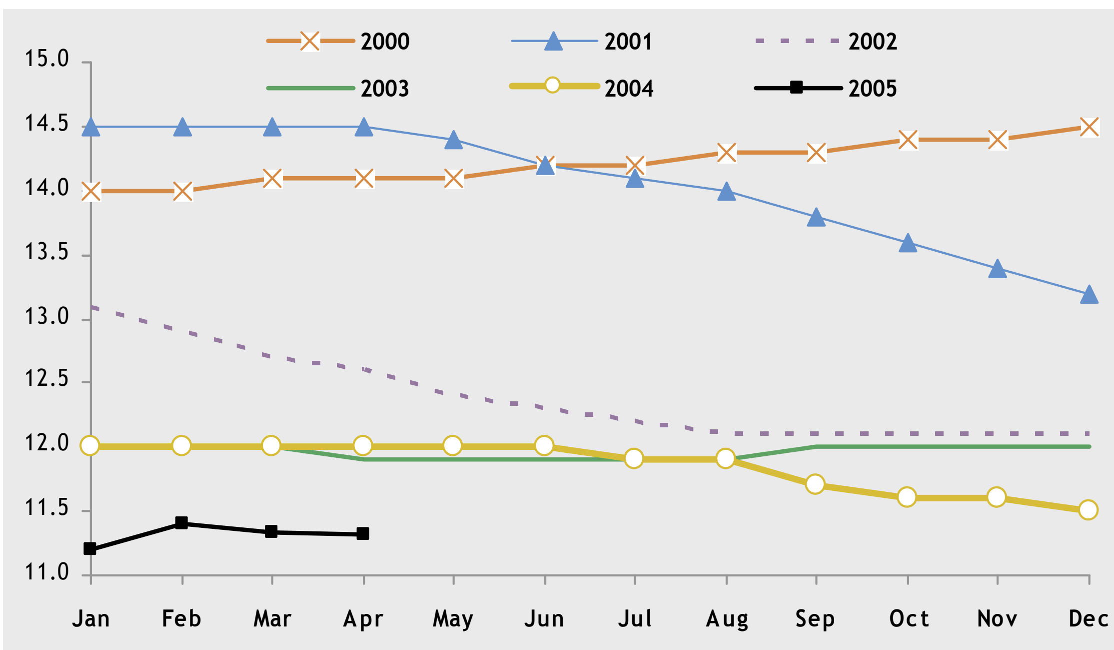
System monthly load factor



Source: Air Transport Association.

Exhibit V: However, airfares have not kept pace with U.S. inflation

LTM domestic yield (¢/mile)

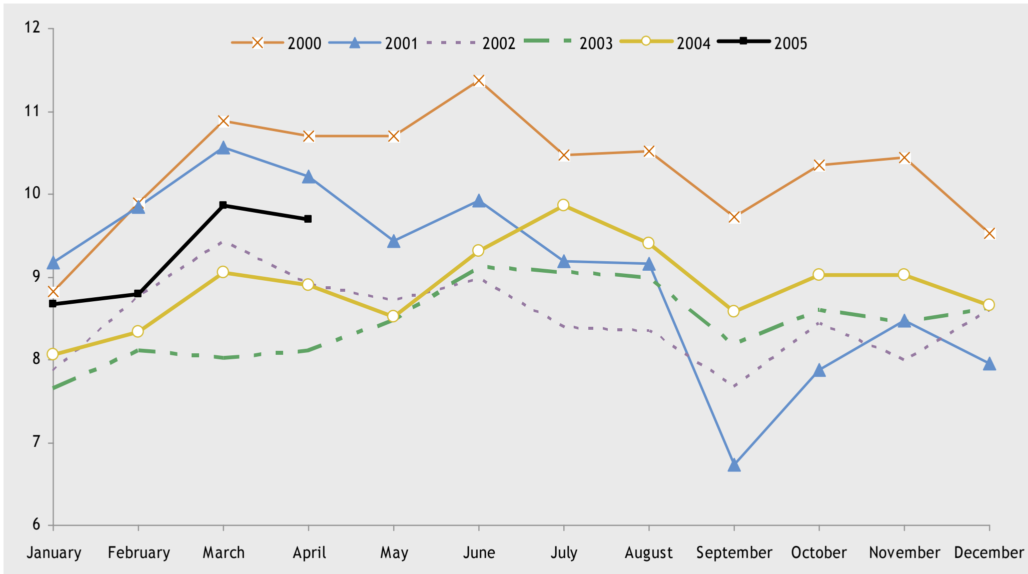


Source: Air Transport Association.

One bit of good news is that unit revenues are higher year over year as a result of the strong traffic performance despite the stagnant yield environment (Exhibit VI).

Exhibit VI: Traffic drives improving unit revenue trends despite weak yields

Revenue per system ASM (in cents)



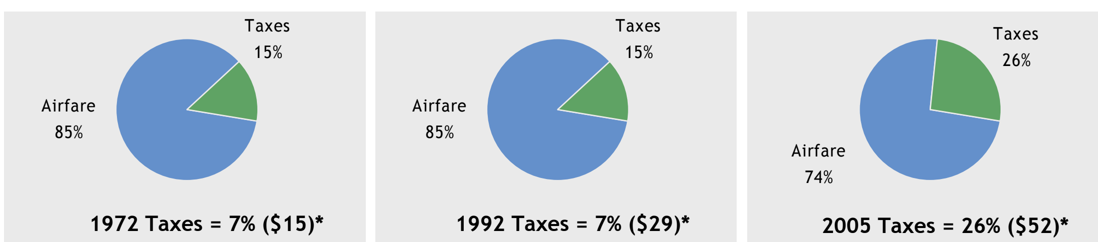
Source: Air Transport Association.

Nevertheless, rising passenger taxes and fuel costs, which are beyond the immediate control of the airlines, have had a pronounced impact on bottom line profits.

The industry's tax burden is compounded by the lack of pricing power to effectively offset the government's need to raise proceeds to fund security measures (Exhibit VII).

Exhibit VII: Is airline travel a sin? Tax burden suggests so…

Taxes/fess on a $200 ticket* have more than tripled



*Sample itinerary assumes one-stop domestic round-trip with maximum passenger facility charge (PFC) per airport; $200 total price includes taxes and fees.
Source: ATA research.

Federal consumption taxes and fees on flyers*

PRODUCT	%
Plane Ticket: One-Stop ($100)[1]	44.9
Plane Ticket: Non-Stop ($100)[1]	26.0
Plane Ticket: One-Stop ($200)[1]	26.0
Plane Ticket: One-Stop ($300)[1]	19.6
Pack of Cigarettes ($4.50)[2]	18.2
Plane Ticket: Non-Stop ($200)[1]	16.5
Plane Ticket: Non-Stop ($300)[1]	13.3
Heavy Truck / Trailer / Tractor	12.0
Gallon of Gasoline ($1.60)[3]	11.5

PRODUCT	%
Heavy Firearms / Ammunition	11.0
Distilled Spirits ($20)[4]	10.7
Pistol or Revolver	10.0
Can of Beer ($1.00)[5]	5.0
Telephone Service	3.0
Ship Ticket ($1,000)[6]	0.3
Bus Ticket	0.0
Rail Ticket	0.0
Luxury Vehicle[7]	0.0

[1] Round-trip with federally approved $4.50 PFC
[2] Taxed at 82¢ per pack
[3] Taxed at 18.4¢ per gallon
[4] Taxed at $2.14 per 750-milliliter bottle
[5] Taxed at 5¢ per can
[6] Taxed at $3.00 per ticket
[7] Until 2003, 3.0% on value > $40,000

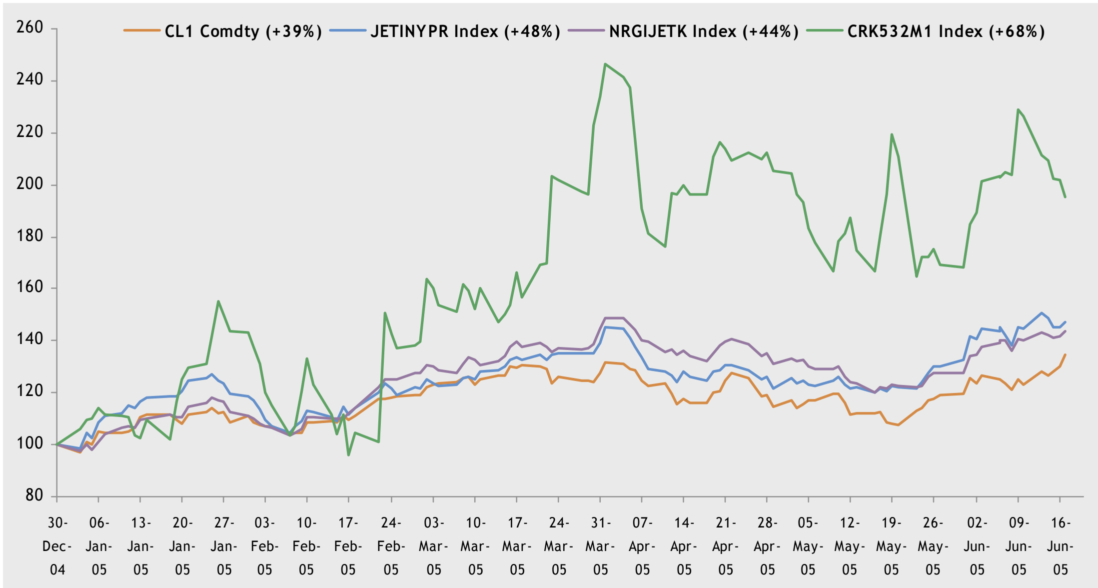
* The federal government also taxes the sale of tires over 40 pounds, coal, wine, vaccines, foreign-issued insurance and selected other items; analysis considers federal taxes and fees only – does not examine state and local taxes, which can be especially high on alcohol and tobacco.

Sources: ATA research; U.S. Internal Revenue Service; Bureau of Alcohol, Tobacco and Firearms (ATF).

It is no secret that oil prices have risen dramatically. More importantly, jet kerosene has been impacted severely by the shortage of refinery capacity. Year-to-date as of June 17, crude oil had risen 39% while jet fuel had increased 48% given the 68% increase in crack spreads (Exhibit VIII). I estimate that the eight successful fare increases in 2005 have thus far at best offset only half of the $16 per barrel increase in raw crude oil.

Exhibit VIII: Crack spreads have risen faster than crude prices ytd

Relative change in oil (CL1 Comdty), jet fuel (JETINYPR, NRGIJETK) and crack spread (CRK532M1) ytd 2005 through June 17



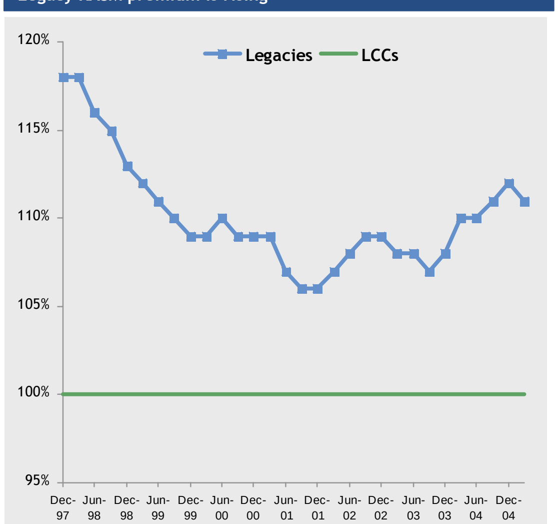
Source: Bloomberg and JPMorgan.

Are the legacy airlines standing still?

Despite accusations to the contrary, the legacy airlines are not standing still. The legacy majors have increased their unit revenue premium relative to the low cost carriers by about five percentage points while narrowing the cost disadvantage by more than one third (Exhibit IX).

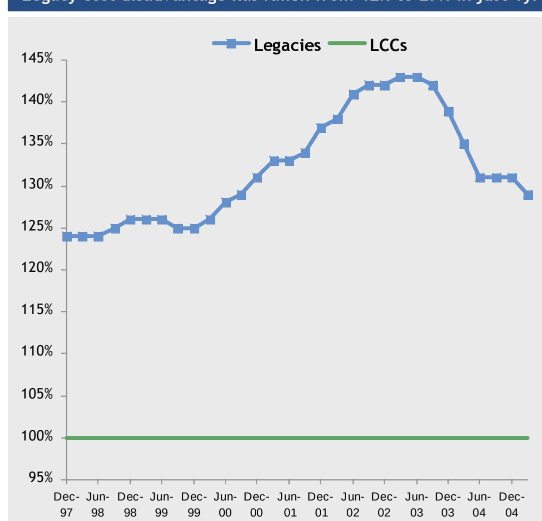
Exhibit IX: Legacy RASM premium rising, cost disadvantage falling

Legacy RASM premium is rising



Source: Company reports and JPMorgan estimates.

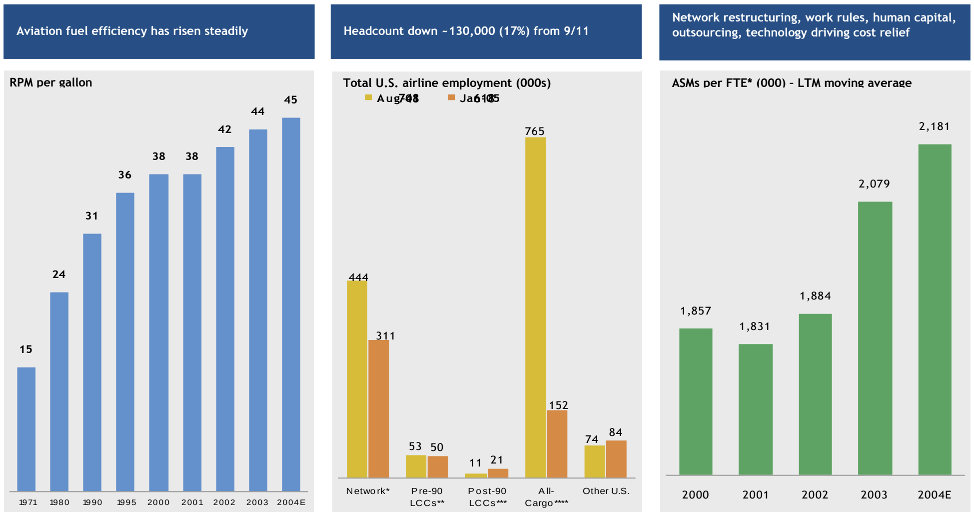
Legacy cost disadvantage has fallen from 42% to 27% in just 1yr



Source: Company reports and JPMorgan estimates.

Fuel and employment productivity have improved, but not fast enough to offset the rise in input prices (Exhibit X).

Exhibit X: Fuel and employment productivity improving, but not fast enough



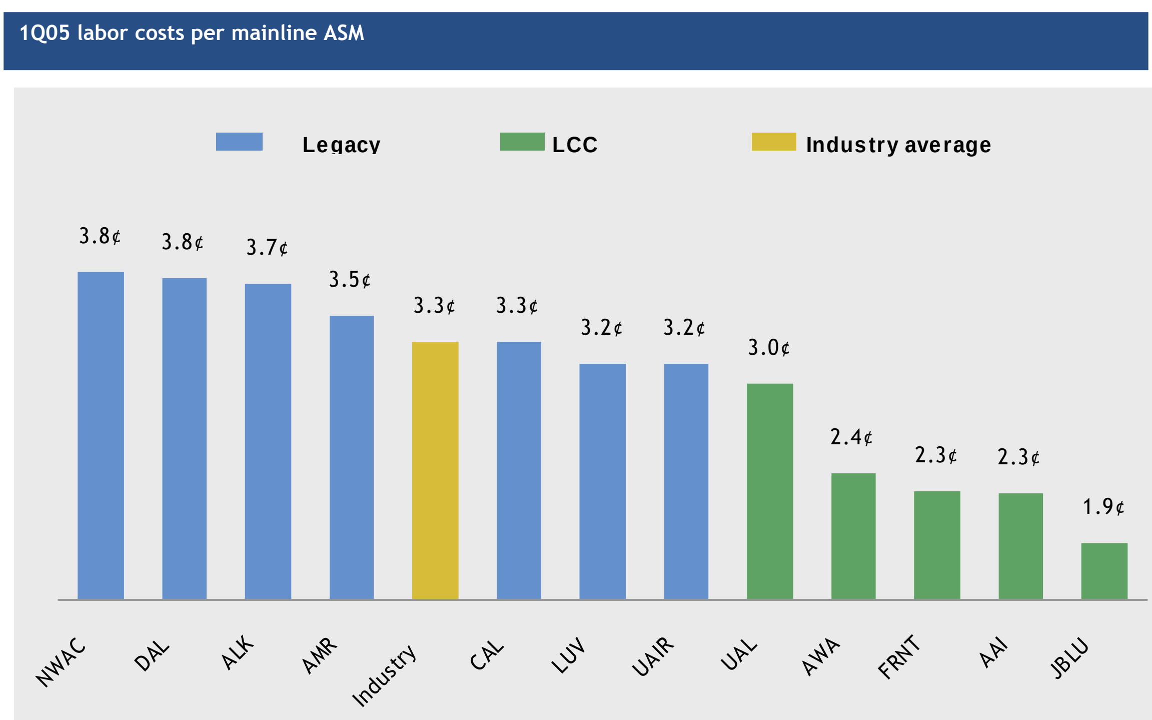
Source: ATA Cost Index for major/national carriers.

* ALK, AMR, CAL, DAL, NWAC, UALAQ, and UAWGQ.
** AWA, ATAH, and LUV.
*** AAI, FRNT, JBLU, and Spirit.
**** Air Transport Int'l, ASTAR/DHL, Express.Net, Evergreen, FedEx, Gemini, Kalitta, Kitty Hawk, Polar, Ryan Int'l, Southern, Tradewinds, UPS, World.
Sources: Air Transport, Association, U.S. Department of Transportation P1a employment report; carrier reports for full-time and part-time workers

*full-time equivalent.
Source: ATA Cost Index for major/national carriers.

The difference between legacy and low cost carrier labor costs has narrowed (Exhibit XI). Nevertheless, the pace of change has been frustratingly slow, evidenced by the current battle at Northwest between mechanics and management and the Continental flight attendants' refusal to approve a new contract.

Exhibit XI : Labor costs converging, still higher for legacy carriers

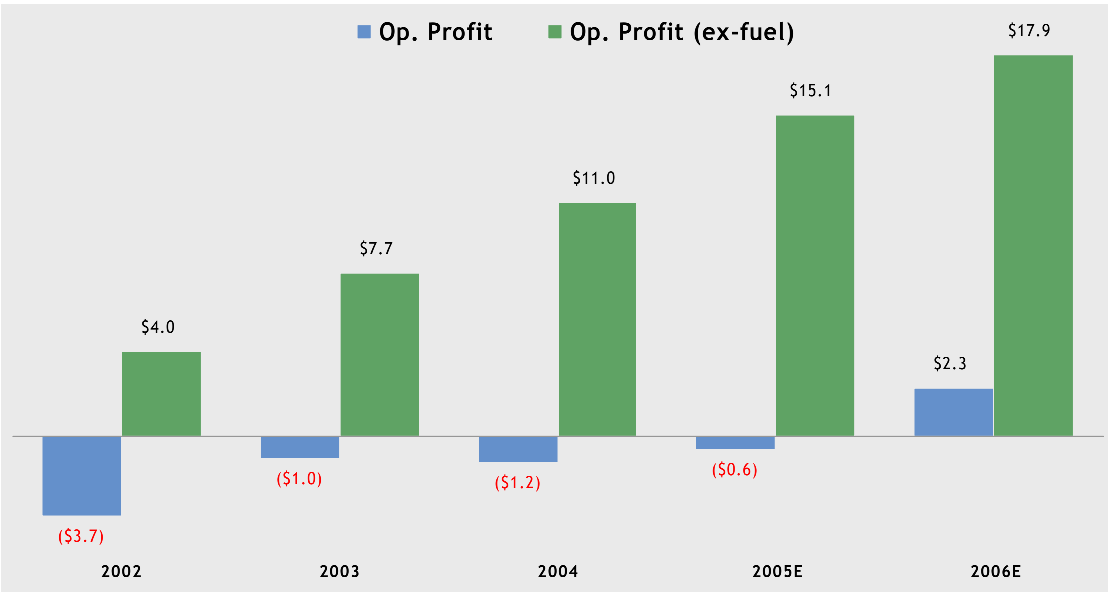


Source: JPMorgan and company reports.

Given the state of the airline credit markets, counterparties are not willing to engage the legacy airlines in fuel hedges without cash collateral. As a practical matter, this makes it impossible for the legacy carriers to hedge fuel costs. I cannot overstate the impact of current and projected oil prices on profits. Based on oil prices from a few weeks back, I estimated then that the difference between operating profits and operating profits excluding fuel in 2005 for the mainline carriers will total more than $15 billion (Exhibit XII).

Exhibit XII: Ex-fuel profitability should continue to rise quickly

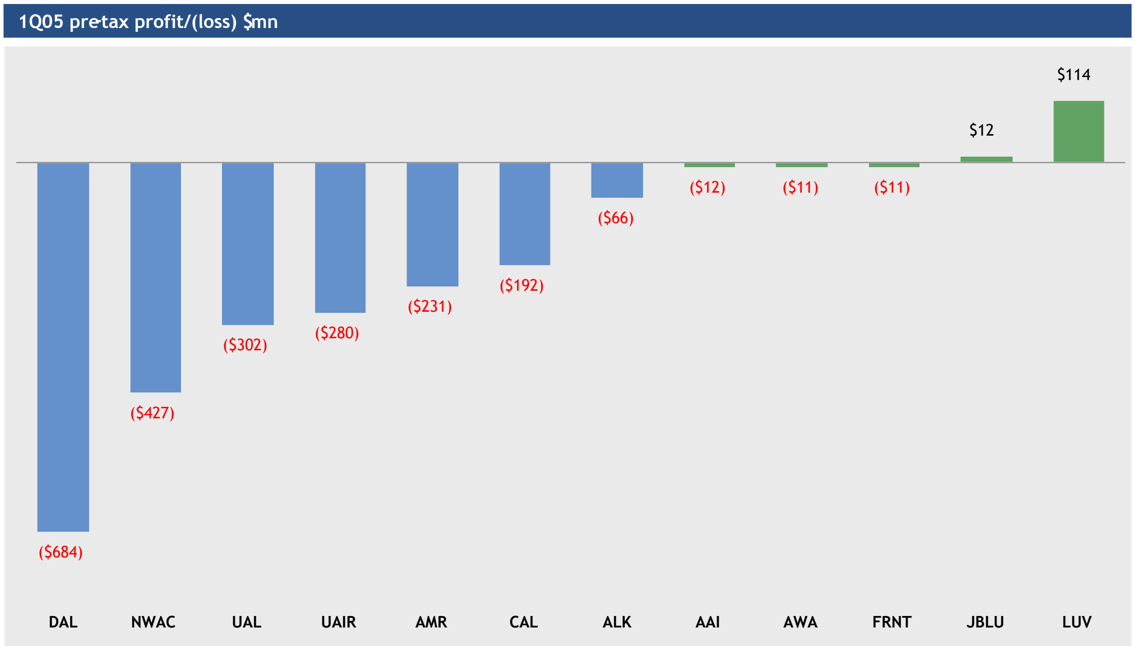
Industry operating profit ($ billions)



Note: **Based on U.S. non-regional Equity Research coverage universe (ie. excludes UAL & UAIR).**
Source: Company reports and JPMorgan estimates.

Results for 1Q05 were bifurcated (Exhibit XIII). The legacy airlines lost hundreds of millions each, while the low cost carriers reported much closer to break-even results in the seasonally weak quarter.

Exhibit XIII:1Q05 profitability was weakest at legacy carriers



Source: Company reports and JPMorgan.

How severe is the cash burn?

My published base case year-end forecast of airline liquidity at the big four non-Chapter 11 legacy majors, assuming average fuel costs for the year that are about 14% lower than current prices, shows significant declines in unrestricted cash and investments absent any further incremental capital initiatives (Exhibit XIV). Specifically, AMR will burn more than $700 million net, Continental more than $200 million, and Delta and Northwest each more than $1 billion. Again, these cash burn estimates are inclusive of capital raised year-to-date.

Exhibit XIV: Base case YE05 airline liquidity snapshot

MAINLINE ASSUMPTIONS	AMR	CAL	DAL	NWAC
RPMs (M)	135,673	72,128	106,599	76,953
yr/yr % chg	*4.2%*	*9.7%*	*8.5%*	*5.0%*
ASMs (M)	178,509	89,919	137,929	94,424
yr/yr % chg	*2.6%*	*6.2%*	*6.1%*	*3.3%*
Load Factor	76.0%	80.2%	77.3%	81.5%
yr/yr % chg	*1.2%*	*2.6%*	*1.7%*	*1.3%*
Yield	11.70¢	11.25¢	10.74¢	11.40¢
yr/yr % chg	*1.3%*	*-0.2%*	*-3.0%*	*-0.9%*
Mainline RASM	8.89¢	9.03¢	8.30¢	9.29¢
yr/yr % chg	*3.0%*	*3.1%*	*-0.8%*	*0.7%*
Mainline CASM	9.82¢	9.85¢	9.43¢	10.87¢
yr/yr % chg	*1.0%*	*3.9%*	*-7.9%*	*5.4%*
Mainline CASM ex-fuel	7.34¢	7.46¢	7.06¢	8.25¢
yr/yr % chg	*-3.7%*	*-2.6%*	*-15.8%*	*0.9%*
Fuel Cost/gal.	$1.501	$1.569	$1.474	$1.471

INCOME STATEMENT ($Mn)	AMR	CAL	DAL	NWAC
Total Revenue	**$19,847**	**$10,804**	**$15,831**	**$11,929**
yr/yr % chg	*6.4%*	*10.9%*	*5.5%*	*5.8%*
EBIT	**$102**	**$4**	**($766)**	**($686)**
yr/yr % chg	*NM*	*NM*	*-48.0%*	*204.7%*
EBITDA	**$1,282**	**$396**	**$492**	**($158)**
yr/yr % chg	*10.6%*	*22%*	*303.3%*	*NM*
EBITDAR	**$1,917**	**$1,121**	**$1,203**	**$628**
yr/yr % chg	*8.4%*	*15%*	*293.8%*	*-40.7%*
Net Income	**(682)**	**(263)**	**(1,824)**	**(1,293)**
EPS	**($4.23)**	**($3.93)**	**($12.94)**	**($14.86)**

CASH FLOW ITEMS ($Mn)	AMR	CAL	DAL	NWAC
Beginning unrestricted cash	$2,929	$1,409	$1,799	$2,459
Net Income (Loss)	**($682)**	**($263)**	**($1,824)**	**($1,293)**
+ Depreciation & amortization	1,180	392	1,258	528
+/- Working capital	0	0	0	0
+ I/S Pension expense	390	235	700	500
- Cash pension expense	(310)	(136)	(450)	(420)
Net operating cash flow	**$578**	**$228**	**($316)**	**($685)**
- Non-aircraft capex	(400)	(175)	(375)	(100)
- Aircraft capex	(460)	(45)	(570)	(400)
+ Aircraft back-up financing	345	20	563	300
- Debt & capital lease payments	(807)	(688)	(758)	(601)
+ Debt issued	0	425	675	291
+ Asset sales	0	23	200	160
+/- Other	350	300	0	0
Ending unrestricted cash	**$2,535**	**$1,497**	**$1,218**	**$1,425**

Source: JPMorgan estimates and company reports.

AMR

- We assume AMR raises incremental $350 mn in capital in '05 although not necessary

CAL

- We assume CAL would need to raise an incremental $300 mn in capital in '05 to reach mgt.'s $1.5 bn YE05 target
- $425 mn of debt issued includes $75 mn of OnePass and $350 mn of Air Mike deal in 2Q05.

DAL

- $875 mn of capital raised in '05 includes $295 mn of Amex draw in 1Q05, estimated $300 mn GE second lien in 2Q05, estimated $80 mn other debt raised in 3Q05 and estimated $200 mn asset proceeds in 3Q05

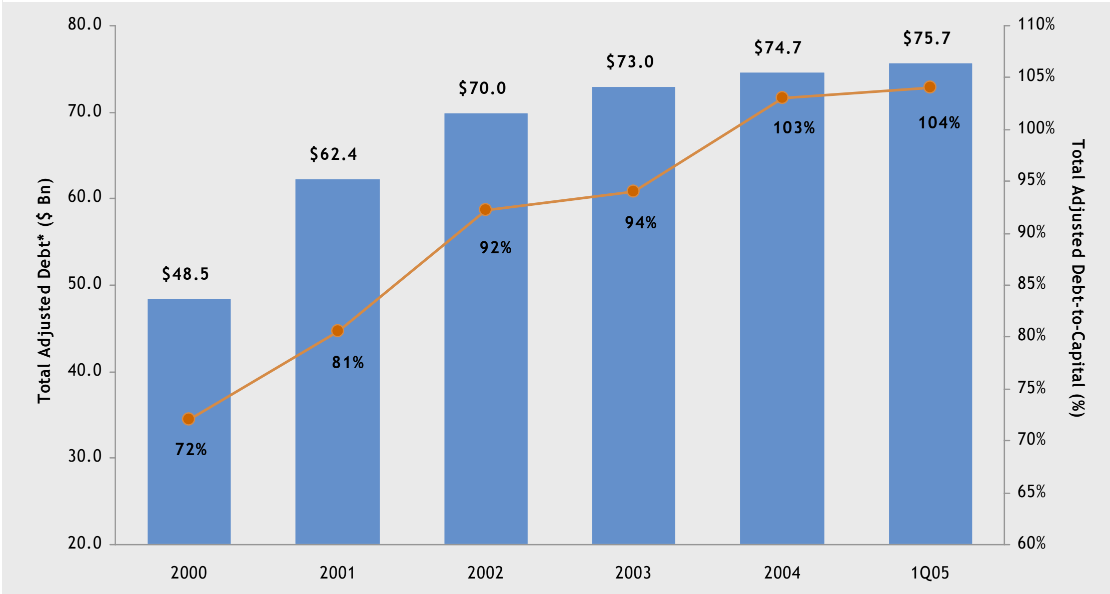
NWAC

- Estimated $450 mn of capital raised in '05 debt issued includes $118 mn Pinnacle note in 1Q05, $101 mn Tokyo real estate deal in 2Q05 and estimated $160 mn from asset sales.

The industry's ability to add incremental debt, although seemingly never quite exhausted, is rapidly diminishing. Since 2000, airlines have borrowed more than $27 billion. Leverage adjusted for aircraft leases has increased from 72% of adjusted capital to 104% (Exhibit XV).

Exhibit XV: Industry added >$27 billion in debt since 2000

Since 2000, total debt for majors up $27 bn; leverage up 32 points

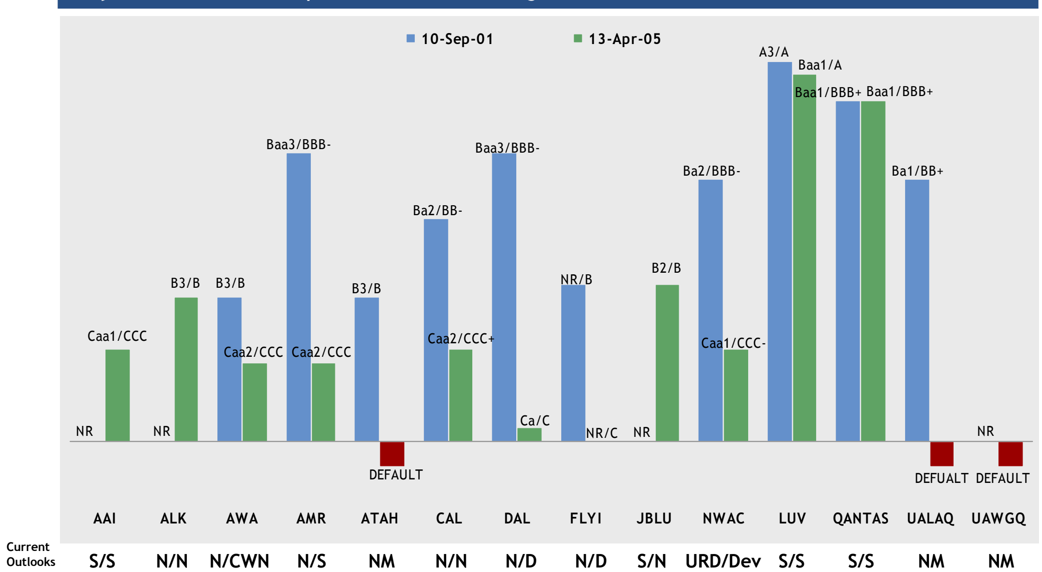


*Total balance sheet debt plus operating leases capitalized at 8x rent (annualized for 1Q05) for AAI, ALK, AWA, AMR, CAL, DAL, JBLU, NWAC, and LUV.
Source: Company reports and JPMorgan.

The credit rating agencies have been busy downgrading airline credit ratings (Exhibit XVI). Delta senior unsecured ratings have fallen 10 notches to Ca/C since the day before the September 11th attacks. Northwest ratings have fallen five and seven notches respectively to Caa1/CCC-. Continental ratings have fallen six and four notches to Caa2/CCC+. Even AMR, which is in the best credit shape of the legacy majors, has seen its credit ratings cut by eight steps.

Exhibit XVI: The agencies have been busy; Moody's NWAC downgrade likely

Only QANTAS has retained pre-9/11 unsecured ratings



Ratings assigned numerical value from 1 (for lowest rating Ca/CC) to 20 (for highest rating Aaa/AAA), half point increments for split ratings.
Source: Bloomberg, S&P, and Moody's.

How can the legacy airlines raise capital?

In order to raise capital, the legacy airlines have turned to non-traditional lenders. Delta has sold frequent flier miles forward to American Express and tapped General Electric for a securitized loan. Continental recently sold miles forward as well and borrowed against its last major unencumbered assets (Air Micronesia).

It remains to be seen whether or not other vendors and manufacturers are willing to invest in their airline partners. Nevertheless, the proposed America West /US Airways capitalization includes proceeds from an airframe manufacturer (Airbus), hedge fund, traditional money manager, and airline maintenance provider (Air Canada). Therefore, we can conclude that the legacy airlines could perhaps tap some of these same sources for additional liquidity, especially if pension reform positively impacts the credit standing of the legacy airlines.

Will pension reform force additional legacy airline Chapter 11 filings?

Under some pension reform proposals, the airlines that sponsor defined benefit plans will face incredibly onerous payments. Relative to the 2005 required minimum contribution of $450 million, Delta has disclosed that its projected minimum funding under the current rules will increase by 33% in 2006 to $600 million, by 111% in 2007 to $950 million, and by 255% in 2008 to $1.6 billion. Northwest has yet to disclose minimum payments but I estimate similar figures relative to Delta (Exhibit XVII).

Exhibit XVII: Pension reform/stock market rally <u>needed</u> for legacy survival

US major airlines operating profit/(loss), $Bn

	PBO			Fair Value of Plan Assets			PBO % Funded			Underfunded Amount		
	2004	2003	2002	2004	2003	2002	2004	2003	2002	2004	2003	2002
CAL	$2,863	$2,362	$2,059	$1,281	$1,280	$866	44.7%	54.3%	42.1%	$1,582	$1,079	$1,193
NWAC	$9,254	$8,554	$7,638	$5,425	$4,806	$3,690	58.6%	56.2%	48.3%	$3,829	$3,748	$3,948
AMR	$10,022	$8,894	$8,757	$7,335	$6,230	$5,323	73.2%	70.1%	60.8%	$2,687	$2,664	$3,434
DAL	$12,140	$12,477	$11,682	$6,842	$6,818	$6,775	56.4%	54.6%	58.0%	$5,298	$5,659	$4,907
UALAQ	$13,577	$13,117	$12,673	$7,152	$6,961	$6,298	52.7%	53.1%	49.7%	$6,452	$6,156	$6,375

	Discount Rate			Expected Rate of Return			Actual Plan Return			Minimum Payments*		
	2004	2003	2002	2004	2003	2002	2004	2003	2002	2005	2006	2007
CAL	5.75%	6.25%	6.75%	9.00%	9.00%	9.50%	8.8%	25.2%	-12.0%	$266	$360	$450
NWAC[1]	5.90%	6.75%	7.50%	9.50%	9.50%	10.50%	15.0%	28.2%	-12.5%	$420	$700	$975
AMR[2]	6.00%	6.25%	6.75%	9.00%	9.00%	9.25%	17.8%	23.8%	-0.3%	$310	$600	$800
DAL	6.00%	6.125%	6.75%	9.00%	9.00%	10.00%	12.0%	14.6%	-8.7%	$450	$600	$950
UALAQ[3]	5.84%	6.25%	6.75%	9.00%	9.00%	9.75%	12.1%	22.2%	-9.3%	TBD	TBD	TBD

* Without pension reform.
Source: JPMorgan and company reports.
1. NWAC 2006/207 minimum payments are estimated.
2. AMR 2006/2007 minimum payments are estimated.
3. UAL's 401K/defined contribution costs are far from $0 and may total >$200 million per annum.

In my opinion, Delta and Northwest will be forced to seek Chapter 11 protection and the termination of defined benefit plans (likely during 2006 and perhaps sooner if oil prices rise materially from current levels) unless reform allowing for a longer-term amortization of deficits for sponsors that agree to freeze plan liabilities is passed into law.

Continental is not as exposed to rising payments given the nature of the airline's defined benefit plan relative to Northwest and Delta. Nevertheless, the combination of the current oil price environment, current industry revenue, and higher required pension payments could force Continental to consider Chapter 11 as well in 2006.

AMR has enough liquidity-raising options and current liquidity to perhaps bridge the gap between today's environment and one where industry revenue and stock market improvement make required pension payments more manageable.

The issues surrounding credit balances and annual premiums, while important, are secondary to both the length of the amortization period and the interest rate to value liabilities in the cases of Delta and Northwest.

For AMR, the interest rate assumption and premium payments are most critical given the company's and its workers' desire to maintain defined benefit plans rather than the freezing approach embraced by Delta and Northwest management.

UAL is AMR's largest competitor. Although UAL's replacement defined contribution plan costs are significant, I nonetheless am concerned that AMR (and other legacy majors) will be at a strategic disadvantage to UAL going forward because of UAL's successful elimination of its defined benefit plans.

Are more legacy airline Chapter 11 filings inevitable?
Legacy Chapter 11 filings are not necessarily inevitable. I believe that Delta and Northwest would prefer to avoid the Chapter 11 process. Management's ability to do so is predicated on favorable airline specific pension reform and lower oil prices.

Delta's situation is fairly straightforward. I believe that management will continue to pursue an out of court restructuring. Delta is pursuing options to lower costs further and to bolster liquidity. The company just last week executed another $20 million debt for equity exchange in an ongoing attempt to reduce cash outflows. My view is that Delta will not file for Chapter 11 protection until the pension reform issue is settled if cash reserves remain adequate.

Northwest is dealing with an unsustainable labor situation, especially in regards to its current mechanic costs relative to peers. I expect that Northwest will eventually reach consensual deals on wage reductions with its labor unions. Management has yet to pull many of the liquidity strings that others have executed. I believe that with favorable pension reform and lower labor costs, Northwest's ability to avoid Chapter 11 rises dramatically.

For both Delta and Northwest, the variable with the most direct impact on survivability is oil.

Would pension reform delay necessary industry rationalization?
Most airlines and industry observers believe, as do I, that too many legacy carriers exist today and that further consolidation is inevitable. There are too many hubs and too many airline pricing departments, not too many mainline aircraft in my opinion.

Legacy airline hub and spoke networks were built to provide convenience that the consumer is no longer willing to subsidize through high fares. The legacy network rationalization process is already underway through initiatives such as hub de-peaking and more point-to-point flying.

Further rationalization does not necessarily need to occur in Chapter 11 if the government allows the legacy airlines to pursue mergers that make economic sense. The government could also relax foreign ownership provisions, thereby affording domestic airlines the ability to seek capital from global alliance partners.

If the government affords sponsors the flexibility to stretch payments out over a period of several years, the sponsors must be forced to maintain fiscal discipline in my opinion.
I believe that airlines or other sponsors opting into a longer-term deficit amortization payment option should not be allowed to repurchase stock, pay dividends, or offer increased defined benefits even if funded with cash.

Conclusion

If the proposed pension legislation not supported by the legacy airlines is passed into law, I believe in what the credit markets are telling us, specifically that Delta and Northwest will likely file for Chapter 11 protection in 2006. If the airline defined benefit plan sponsors seek court protection, the PBGC's shortfall will obviously grow dramatically and taxpayers and other defined benefit plan participants will suffer as a result. Nothing is guaranteed, but the ability of the legacy airlines to successfully restructure outside the courts is almost directly tied to pension reform that does not result in onerous near-term deficit reduction contributions. In order to function efficiently, the airline equity and credit markets require some degree of cash flow stability. The government has one of two choices in my opinion. Either pension reform legislation will add to the already high level of cash flow uncertainty or pension reform will provide some degree of comfort to creditors willing to participate in out-of-court restructuring solutions.

Thank you once again for allowing me to speak to you today.